Directors, now is the time to consider safe harbour

30 March 2020
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If ever there were times challenging enough for boards to be considering the financial lifeline that is safe harbour from insolvent trading, these are they.

On a daily basis we are reading news of businesses having to shut down and lay off employees and seeing footage of lengthy Centrelink queues. Boards are working harder than ever to govern their organisations in incredibly uncertain times.

Particularly in uncertain times, directors become very aware of the personal liability implications for permitting an organisation to trade while insolvent – that they could face personal liability for the company's insolvent trading and may, as a consequence, be required to pay compensation to the company from their personal assets, which may in turn lead to bankruptcy.

However, it seems that many boards are not aware of a key piece of legislation which, when properly advised, may lessen their personal liability – s.588GA of the *Corporations Act 2001* (Cth) (**Corporations Act**), known as the safe harbour provisions.

What is safe harbour?

Boards may qualify for safe harbour protection where they put in place an appropriate strategy for the company, which aims to put the company in a better position and allow the company to continue to trade while carrying out that strategy, as opposed to placing a company into external administration.

Safe harbour starts when a board starts developing one or more courses of action which are reasonably likely to lead to a 'better outcome' for the company than the immediate administration or liquidation. What a 'better outcome' is isn't defined – it just needs to be a better outcome than the immediate appointment of an external administrator.

A properly advised board that enacts an appropriate safe harbour strategy will be entitled to rely upon the safe harbour strategy as an 'exception' to any claim of insolvent trading, in the event the company falls into liquidation.

Background to the introduction of the safe harbour provisions

The Corporations Act imposes a duty on directors to prevent a company from incurring a debt (or debts) when the director has reasonable grounds to suspect the company is, or may become, insolvent. Under Australian law, a company is considered to be insolvent when it is unable to pay its debts as and when they fall due and payable.

Although there are some defences available to a director, liability for insolvent trading can expose a director to a range of penalties including civil or criminal penalty orders or orders to pay compensation for debts incurred by the company whilst insolvent. Director and officer (**D&O**) insurance can't be relied upon to come to rescue in these circumstances, as these policies often exclude claims relating to insolvent trading.

The Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017, which introduced the safe harbour provisions, resulted from concerns by government that directors were not fully engaged in turning around the performance of companies in financial difficulties – choosing voluntary administration instead – because they had potential liability for insolvent trading. In other words, they were putting their own interests ahead of the needs of the needs of the company.

You need the 'right' advice

For a company to enter safe harbour, a board requires a range of specialist advice – an insolvency or corporate lawyer, a turnaround expert experienced in reconstructions and trade-outs, a crisis communications adviser and a specialist governance adviser to ensure that governance processes support the turnaround. Your local lawyer or tax accountant is not the person for this job.

These advisers will assist the board to rapidly put in place strategies that are aimed at achieving a 'better outcome' and ensure that the company's systems and processes more accurately monitor the company's operating position and support the board's decision making. This is so that the board knows exactly what the company's financial position is, its board papers and minutes appropriately document its activities, and how and why the desired outcome is still a 'better outcome'.

Not all companies will be eligible to call safe harbour, because in order to enter into a safe harbour strategy, companies must (among other things) be able to pay their employee entitlement obligations in full and on time, pay their tax obligations and have existing and up-to-date D&O insurance. Accordingly, the sooner boards engage with appropriately experienced experts, the greater their ability to access safe harbour.

The government's additional response to COVID-19

The Australian Government is responding to the unprecedented environment we're now experiencing as a result of the COVID-19 pandemic, by offering further assistance to directors and companies in financial difficulties. As part of its second stimulus package, the government announced some temporary changes to the insolvency laws, including a moratorium on directors' personal liability for insolvent trading which may arise from debts incurred during a six-month period from 25 March 2020 (to be s.588GAAA of the Corporations Act).

While incredibly beneficial, this moratorium is not a 'get out of jail free card', in that criminal penalties will still apply to debts incurred dishonestly or fraudulently during this period, and directors risk complacency if they don't take other action to get the best available advice.

Act now and seek appropriate advice

So, what to do? Boards should not linger in seeking skilled advice. This could make all the difference for your employees, members and service recipients, not to mention directors' reputations and the company's long-term sustainability.

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